14 January 2013

Westpac Institutional Bank

No looking back

Q4 CPI preview: 18 January, 10:45am

- **We estimate that consumer prices were flat over the December quarter, lifting annual inflation to 1.1%.**
- **We expect moderate price rises across a range of categories, offset by a seasonal fall in food prices.**
- **The lagged impact of past exchange rate strength is a significant source of uncertainty. A negative outturn is quite possible.**
- **However, the forces dampening inflation over the past year are fading, and the RBNZ is firmly focused on the medium-term inflation outlook.**

Summary

We expect the CPI was roughly flat in the December quarter, with a (mostly seasonal) fall in food prices offset by smaller price increases in a range of categories. On an annual basis, we expect that inflation crept up to 1.1% from its September low point of 0.8%.

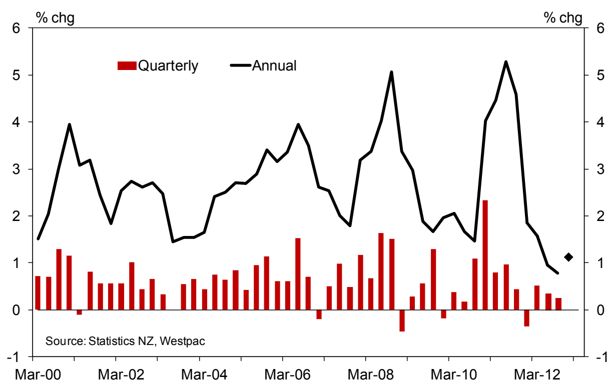
Several factors – in particular, the lagged impact of the high exchange rate – have caused inflation to come in below market expectations for the last few quarters. We could easily see another surprise in the same direction. However, the implications for the medium-term inflation outlook – and hence for the RBNZ – may be limited. The factors that have dampened inflation to date will fade over the coming year, while accelerating construction activity is set to push prices up.

Details

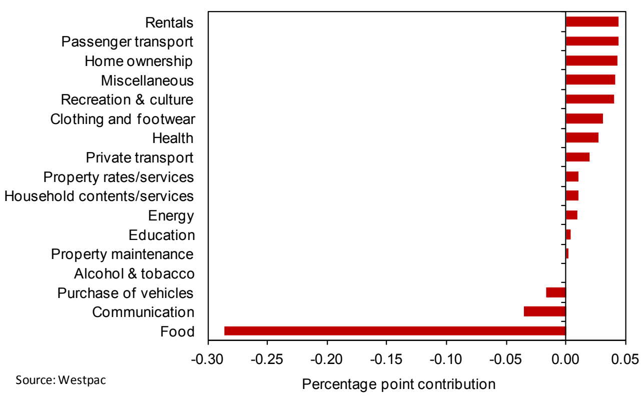
We expect the most enduring positive contributions to come from the strengthening housing market, via rising rents, new housing costs and real estate fees. These are likely to be bolstered for the quarter by the usual seasonal increases in international airfares, accommodation and clothing, although the persistently high exchange rate could dampen the scale of these increases.

On the downside, the main factor will be a 1.5% drop in food prices, already largely signalled in the monthly data for October/November. Much of this fall is seasonal, but dairy and grocery prices also still seem to be easing on the back of wholesale price falls earlier in the year.

Consumer Price Index



Forecast contributions to quarterly change



There are a few other categories where prices have fallen in recent quarters, and may do so again in December:

- Used car prices have eased recently as the effects of the Japanese tsunami and the introduction of tighter emissions standards have unwound – we have pencilled in a further 0.5% fall this quarter.
- Telecommunication prices have been competed substantially lower over the last couple of years, and we have assumed a further 1% fall (though we haven't tracked any specific changes to pricing plans in the latest quarter).
- In the September quarter there was a surprising fall in property maintenance costs (i.e. handymen), possibly

reflecting Fletcher EQR's clamp-down on earthquake repair costs. However, with larger-scale repairs and rebuilds (not covered by EQR) becoming more prevalent, we don't expect this to persist. We've tentatively gone for a zero price change in this category this quarter.

Other categories should see little action. December is mostly an 'off' period for annual price reviews such as local body rates (though a small fraction of rate increases will be carried over into the December quarter), and there was little change in fuel prices, with petrol prices down but diesel prices up.

Market implications

If inflation turns out as forecast, we should see little market reaction – our pick is just a little below both the consensus and the RBNZ's forecast back in December (0.1% for the quarter and 1.2% over the year). However, as our forecast is the sum of a big negative and many small positives, the actual outcome could easily swing either way. The impact of earlier exchange rate rises is a key risk factor. In recent times this has had a bigger dampening effect on tradable goods prices than history would have suggested.

A negative outturn for the quarter wouldn't be a concern in itself – the CPI is not seasonally adjusted and Q4 tends to be the low point for inflation (four of the last six December quarters have been negative). However, an outturn sufficiently weak to keep annual inflation below the bottom edge of the 1-3% target band could generate a market reaction.

However, RBNZ Governor Wheeler has emphasised that his focus is on the medium-term inflation outlook, and the factors currently depressing prices are likely to fade over the coming year: the NZ dollar is no longer persistently rising and global food prices are on the rise. Meanwhile, the Canterbury rebuild is accelerating, house-building in Auckland has begun to respond to rising prices, and construction costs are set to increase. Right now, current inflation is not a particularly good guide to the future.

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